Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:NR:DEN:Postf-126295-02
VLHamilton

date: JAN 13 2003

to: [redacted], Team Manager
Group [redacted]

from: Area Counsel
(Natural Resources:Houston)

subject: [redacted]--Rights of Way Transfers
Taxpayer: [redacted] **Company**
EIN: [redacted]
Last Known Address: [redacted]

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

This memorandum is in response to your request for Area Counsel Advice on the below described issues. On August 21, 2002, we sent you the NSAR and at the same time sent it to the National Office for ten day review. We subsequently determined that the analysis in Issue 6 was incorrect, and we withdrew that issue from National Office consideration. The National Office had some non-substantive revisions on Issues 3-5. Issues 1 and 2 were unchanged. We are herein sending you the final NSAR with these changes incorporated, but omitting Issue 6. We herein withdraw our analysis of Issue 6 as contained in the August 21, 2002 draft and will address that issue on your further request.

ISSUES

1. Whether acquisitions of non-exclusive right of way easements by [redacted] Corporation (hereinafter

"[redacted]") constitute sales or exchanges for Federal income tax purposes.

2. Whether [redacted]'s transfers of non-exclusive use of right of way easements to customers of its [redacted] constitute sales or exchanges for Federal income tax purposes.

3. In connection with the grants of right of way easements to [redacted], whether [redacted] is entitled to deduct unpaid amounts that are based on the net present value of future payments to the original grantor of the easement.

4. In connection with the grants of right of way easements to [redacted], whether [redacted] is entitled to deduct amounts paid to the grantors of the easements in advance of [redacted]'s use of the easements.

5. In connection with [redacted]'s transfers of non-exclusive use in the right of way easements to its customers, whether [redacted] must recognize the income connected with the transfers upon receipt of payment in advance of the customers' use of the easements.

CONCLUSIONS

1. [redacted]'s acquisitions of non-exclusive right of way easements are not sales or exchanges for Federal income tax purposes.

2. [redacted]'s transfers of non-exclusive use of right of way easements in connection with the use of [redacted]'s [redacted] are not sales or exchanges for Federal income tax purposes.

3. In connection with [redacted]'s acquisitions of non-exclusive right of way easements, [redacted] is not entitled to deduct any unpaid amounts for the use of the easements based on the net present value of future payments owed to the grantors of the easements.

4. [redacted] is entitled to deduct amounts prepaid to the grantors of the non-exclusive right of way easements for use of the easements to the extent that such use is a cost

associated with [redacted]'s long-term contracts.

5. In connection with [redacted]'s transfers of use in the right of way easements to its customers, [redacted] must recognize the income connected with the transfer upon receipt of payment made in advance of the use of the easements.

FACTS

Background

[redacted], Inc. (hereinafter ("[redacted]") is a [redacted]

Commencing in calendar year [redacted], [redacted] along substantially all of its [redacted]. [redacted] acquired non-exclusive right of way easements for the [redacted]. These easements are generally along railroad rights of way.

[redacted] a [redacted] in one conduit that normally includes [redacted]. The second conduit is an empty spare. [redacted] intends to retain ownership of at least [redacted] for use in its own [redacted] operations.

In connection with its [redacted] business, [redacted] contracts to provide [redacted] to customers. These contracts are long-term contracts with the customers, as such contracts are defined under section 460(f).[1]

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[1] Section 460(f) provides that the term "long-term contract" means, as relevant here, any contract for the building, installation or construction of property if such contract is not completed within the taxable year in which

[redacted] transfers the constructed systems to its customers under agreements called an [redacted] (hereinafter "[redacted]"). The [redacted] themselves are transferred to the customers under exclusive [redacted]. The remaining property needed for using the [redacted], e.g., underlying rights, defined as rights of way, easements, licenses and other agreements relating to the grant of rights and interest in and/or access to the real property underlying the [redacted], and [redacted], are transferred under non-exclusive [redacted].[2]

Upon request of the customer, on a segment by segment basis, the [redacted] agreements provide that [redacted] will grant a non-exclusive sub-easement, sub-right of way, or sub-underlying right at no additional cost. [redacted] agrees to provide the underlying rights with respect to a segment as long as such provision will not impose on [redacted] any additional costs (unless the customer assumes such costs). Even if a sub-easement is granted, it terminates, and easement will revert and be reconveyed to [redacted] at the expiration of the term of the [redacted].

The [redacted] term extends from acceptance of the project by the customer to the end of the economically useful life of the [redacted] and [redacted]. But if at any time during or after the last year of a "minimum period", i.e., [redacted] years

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such contract is entered into. Treas. Reg. § 1.460-1(b)(2) provides that a contract is a contract for building, installation or construction of property if the building, installation or construction is necessary for the taxpayer's contractual obligations to be fulfilled or if such building, installation or construction of that property has not been completed when the parties enter into the contract. If a taxpayer has to construct an item to fulfill its obligations under the contract, the fact that the taxpayer is not required to deliver that item to the customer is not relevant. Whether the customer has title to, control over or bears the risk of loss from the property constructed by the taxpayer is also not relevant. For contracts entered into before Jan 11, 2001, Notice 89-15, 1989-1 C.B. 634, Q&A 4, provides for the same.

[2] See Chief Counsel Advice 200234039 (May 17, 2002), in which the Service determined transfers of [redacted] and a share of the conduit and regeneration facilities for the economic life of the property was a sale for federal income tax purposes.

after construction commences, the customer fails to use any of [redacted]

Taxes

In general, the [redacted] provides that [redacted] will pay the taxes, fees and other governmental impositions, to the extent they cannot be separately assessed, and the customer will reimburse [redacted] for its proportionate share of such tax, based on the methodology used to impose the tax, e.g., relative property interests or projected revenue. If the tax is based on the latter, then the customer's share will be based on the relative number of customer [redacted] in the affected portion of the segment compared to the total number of [redacted] or based on the customer's proportionate share of the total [redacted] count in the affected portion of the [redacted].

[redacted]'s Treated as Sales and Purchases

The [redacted] agreement provides that the grant of the [redacted] is treated as the sale and purchase of the [redacted] and the corresponding interest in [redacted]'s rights in the associated property for accounting and federal, state, and local tax purposes. Thus, for the issue at hand, [redacted] treats the transfer of the right of way easements as a sale.

Right of Way Agreements

In connection with the construction of [redacted]'s [redacted], [redacted] has obtained grants of right of way easements from various railroads, public transportation authorities and other entities. These agreements allow [redacted] to construct, operate and maintain its [redacted] on the easements.

The easement grants are usually along segments of railroad tracks. The term is a base term, generally [redacted] years. In the grants reviewed, there is also the right to at least

one renewal of [redacted] years. In one agreement, [redacted] renewals options potentially extend the agreement to [redacted] years. In one agreement, the grant was for a perpetual easement.

In all the contracts reviewed except one, the cost of the right of way easement to [redacted] does not vary with the number of conduits laid or made operational. In one case, that of [redacted] Company (hereinafter "[redacted]"), [redacted]'s putting into operation a second conduit does increase [redacted]'s liability for the easement.

Provision in these easement grants is usually made for the recording of the easement, although this is optional and at [redacted]'s determination. From a preliminary review of [redacted] County property records, there is no indication of any of [redacted]'s easements being recorded in this County, neither those transferred to [redacted] nor those transferred from [redacted].

The easement agreements also recognized that [redacted] will be delegating or assigning portions of its rights and duties under the transfers of easements to [redacted] to the [redacted] customers of [redacted]. In some cases, consent of the grantor is required; in other cases no consent is required but notice must be given to the grantor. The use of the easement by [redacted]'s customers in connection with the use of [redacted] capacity and [redacted] in many cases was not considered a legal assignment.

Generally, [redacted] was required to remain fully and primarily liable for all the duties, burdens and obligations under the original easement agreement, even though rights of use were transferred to [redacted]'s customers. In some cases, there were provisions for a novation of the agreement, taking [redacted] out of the chain entirely. All of the agreements contemplate the eventual extinguishment of the easement, in some cases with the [redacted] passing to the grantor. In general, the title to the easement did not pass to [redacted] with the easement grant. Further, none of the easement grants were for the exclusive use of the property. Even in connection with the perpetual easement, the grantor has the right to grant additional easements.

Accounting

[redacted] uses the [redacted] of accounts for its long-term contracts, guided by completed

[redacted]. In accordance with [redacted]'s incremental method of accounting for Federal income tax purposes, [redacted] allocates its total cost of the right of way easements to the first customer contract on a given route. This was so even though [redacted] and other [redacted] customers would also be using the same right of way easements.

[redacted] calculates the total cost of these easements for purposes of capitalizing the appropriate costs to cost of goods sold associated with the customer contracts deduction in two different ways, depending on the provisions of the underlying easement grants. Where these contracts provide for periodic payments over the term of the agreement, [redacted]

[redacted]

DISCUSSION

Law--Issues 1-5

Section 461 provides that the amount of any deduction shall be taken in the proper taxable year under the method of accounting used in computing taxable income. Section 461(h)(1) provides that in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs. Section 461(h)(2)(A)(iii) provides that in connection with the provision of services and property to the taxpayer, when the liability of the taxpayer arises out of the use of the property, then economic performance occurs as the taxpayer uses the property.

Treas. Reg. § 1.461-4(d)(2) provides that except as otherwise provided in paragraph (d)(5), if the liability of a taxpayer arises out of the providing of services or property to the taxpayer by another person, economic performance occurs as the services or property is provided. Treas. Reg. § 1.461-4(d)(2)(ii) provides that in any case where the liability of a taxpayer described in paragraph (d)(2)(i) is an expense attributable to a long-term contract with respect to which the taxpayer uses the percentage of completion method, economic

performance occurs as the services or property is provided; or, if earlier, as the taxpayer makes payment in satisfaction of the liability. This principle is illustrated in Treas. Reg. § 1.461-4(d)(7), Example 3. Payment, however, must be such that a cash basis taxpayer would have a payment and does not include the furnishing of a note or other evidence of indebtedness. Treas. Reg. § 1.461-4(g)(1)(ii)(A).

Treas. Reg. § 1.461-4(d)(3)(i) provides that economic performance with respect to a liability which arises from the use of property by the taxpayer occurs ratably over the period of time the taxpayer is entitled to the use of the property, e.g., periodic easement payments.

The economic performance provisions of section 461 were enacted to prevent current deductions for obligations payable in the future or obligations to provide property or services in the future without taking into account the time value of money. Although Congress considered providing a system for discounting such deductions to the present value, Congress instead enacted the economic performance requirements under section 461 because it was simpler and easier to administer. S. Rep. No. 169, 98th Cong., 2d Sess 266-267 (1984) (Deficit Reduction Act of 1984 Senate Finance Committee Report.)

Section 483 governs interest payments on certain deferred payments. The section provides for the determination of an interest component on a contract for sale or exchange of property where, with certain exceptions, any payment on account of the sale or exchange is due more than six months after the date of the sale or exchange under which some or all of the payments are due more than one year after the date of such sale or exchange and where there is total unstated interest.

Total unstated interest is defined under section 483(b) as an amount equal to the excess of the sum of the payments to which the section applies which are due under the contract over the sum of the present values of such payments and the present values of any interest payments due under the contract.

Section 451 provides that the amount of any item of gross income is to be included in the gross income for the taxable year in which received by the taxpayer, unless such amount is to be properly accounted for under a different period under

the taxpayer's method of accounting. Treas. Reg. § 1.451-5(b)(3) provides that in connection with advance payments associated with long-term contracts, such payment is included in income in the taxable year in which properly included in gross receipts pursuant to the taxpayer's method of accounting for the long-term contract.

Section 61 provides that gross income includes, as relevant here, rental income. Treas. Reg. § 1.61-8(b) provides that gross income includes advance rentals, which must be included in income for the year of receipt, regardless of the period covered or the method of accounting employed by the taxpayer.

Analysis

Issues 1 and 2

[redacted]'s acquisitions of the non-exclusive right of way easements on which [redacted] constructed its [redacted] are not sales or exchanges for Federal income tax purposes. Nor are [redacted]'s transfers of a non-exclusive use of the right of way easements to its customers sales or exchanges for Federal income tax purposes.

The grants of the right of way easements to [redacted] are, except for a few exceptions, for a specific term of years. Following that term, the easements, with or without the underlying [redacted], revert to the grantor. These grants are not exclusive, the grantor retaining rights of use for itself or other grantees. Similarly, the transfers by [redacted] of the non-exclusive use in the easements to its customers are only for a term of years. These transfers are also non-exclusive, allowing [redacted] itself to use the easements as well as grant additional non-exclusive easements in the same property.

Under these circumstances, the transfers of the right of way easements are not sales or exchanges for Federal income tax purposes. First, an instrument that only allows for the use of real property for a limited term does not constitute a sale of such property. Cornish v. United States, 84-2 U.S.T.C. ¶ 9692 (N.D. Ala.). In such case, the reversion is not contingent, and hence the transfer is not a sale. Gibertz v. United States, 808 F.2d 1374 (10th Cir. 1987).

In all but one case, the easement grants to [redacted] are for a term of years. In turn, all of [redacted]'s transfers of the non-exclusive easements to its customers are for a term of years. [redacted] can grant no more than it has. Nor are [redacted]'s transfers of non-exclusive use in the perpetual easements perpetual. The term of the [redacted], which transferred the easements along with tangible property, is only for the economic life of the property. After [redacted] years, three months of non use of the [redacted] facilities by the customer results in a reversion of all [redacted] property back to [redacted]. Thus, at the time the tangible property is no longer functional, the perpetual easements revert to [redacted]. Therefore, all of [redacted]'s transfers of easements to its customers are for limited terms. As such, none are sales or exchanges.

In order for the grant of an easement to constitute a sale of land, the easement must be perpetual. Cornish, 84-2 U.S.T.C. ¶ 9692; H.L. Scales v. Commissioner, 10 B.T.A. 1024 (1928), acq., C.B. VII-2, 35 (1928); Rev. Rul. 72-255, 1972-1 C.B. 221. Even the grant of a perpetual easement did not constitute a sale of land where the grantor had reversion rights to the areas if they were abandoned for the original purpose of the easement. Bledsoe v. United States, 67-2 U.S.T.C. ¶ 9581 (N.D. Okla.). In the instant case, all but one of the easement grants to [redacted] are for a term of years, and all of [redacted]'s easement transfers to its customers were for a term of years. This includes even [redacted]'s transfers associated with the perpetual easement, as explained above. Further, the term "sale" generally requires the transfer of all right, title and interest in the property transferred. Nay v. Commissioner, 19 T.C. 114 (1952). See also Wineberg v. Commissioner, 326 F.2d 157 (9th Cir. 1963). [redacted] neither received nor transferred all right, title and interest in the right of way easement.

Finally, it is generally held that when the grantor retains any beneficial interest in the land covered by the easement, the transfer is not a sale of the land. Vest v. Commissioner, 481 F.2d 238 (5th Cir. 1973), cert. denied, 414 U.S. 1092 (1973); Rev. Rul 72-255, 1972-1 C.B. 221; Rev. Rul. 54-575, 1954-2 C.B. 145. In the instant case, all of [redacted]'s grantors, even the one granting the perpetual easement, retained rights to use the same property. In turn, [redacted] retained the right to use the same easement granted to its customers for its own [redacted] use. In light of

the above, [redacted]'s receipt of the right of way easements and its subsequent grant of such are not sales or exchanges of interests in land. The transactions are in the nature of a lease, or are a lease in the nature of an easement. See, e.g., Vest v. Commissioner, 481 F.2d 238 (5th Cir. 1973), cert. denied, 414 U.S. 1092 (1973); Nay v. Commissioner, 19 T.C. 114 (1952).

Issue 3

[redacted] is not entitled to deduct an amount equal to the discounted value of all future payments due under the easement agreements. [redacted] apparently argues that it is entitled to deduct the discounted value of all future payments under section 483. This section provides for the determination of interest in connection with a sale or exchange of property if the contract provides for one or more payments due more than one year after the date of the sale or exchange and the contract does not provide for adequate stated interest. The unstated interest is determined by a formula of the sum of the payments due under the contract over the sum of the present values of such payments.

Section 483 is not applicable in this case. As discussed above, [redacted]'s acquisitions of the right of way easements are not sales or exchanges for Federal income tax purposes. Hence, section 483, which requires a sale or exchange, is inapplicable. Moreover, even if there were a sale or exchange, section 483 does not provide authority for deducting the discounted value of future payments due under the easements. Section 483 is an interest imputation provision that potentially treats a portion of the deferred payments as interest. Instead of section 483, section 461 and its regulations, where economic performance governs the timing of deductions, are the applicable law.

[redacted] acquires from its grantors non-exclusive easements, in most cases for a term of years. Part of these easements is used by [redacted] itself; part is further transferred to [redacted]'s long-term contract customers.[3] [redacted] will use its part of the

[3] [redacted]'s grants of [redacted] in its [redacted] system clearly fall within the definition of a section 460 long-term contract. Construction is taking place, and the building, installation or construction is necessary for [redacted] to fulfill its obligations under the [redacted] contracts. See

property over the term of the easement grants. As such, [redacted]'s liability for these easements where there has been no prepayment is governed by section 461(h)(2)(A)(iii).

This section provides that except as otherwise stated in the regulations, where property is provided to the taxpayer and the liability of the taxpayer arises out of the use of the property by the taxpayer, economic performance occurs as the taxpayer uses such property. See Treas. Reg. 1.461-4(d)(2)(i) and Examples 6-9 of Treas. Reg. § 1.461-4(d)(7). [redacted] uses the easements over the term of years. This is the period over which economic performance occurs. Hence, [redacted] is only entitled to deduct the liability associated with the easements ratably over the term of the easement.

The expense associated with the easements granted to [redacted] is in part a liability attributable to long-term contracts with respect to which the taxpayer uses the percentage of completion method. In such case, economic performance cannot occur any earlier than the use of the property or when the taxpayer makes payment. Treas. Reg. § 1.461-4(d)(2)(ii). In this case, [redacted] has not prepaid the liability. Consequently, it is not entitled to a deduction any earlier than when such property is actually used, again, ratably over the term of the easements. These amounts would be allocated between the long-term contracts and [redacted]'s self-constructed assets.

Evidently, in enacting the economic performance provisions of section 461, Congress considered providing a system for discounting the stream of future liabilities to a present value for purposes of calculating a current deduction. Congress rejected this approach and instead enacted the economic performance requirements of section 461 because it was simpler and easier to administer. S. Rep. No. 169, 98th Cong., 2d Sess. 266-267 (1984) (Deficit Reduction Act of 1984, Senate Finance Committee Report.) Under the provisions of section 461 and its legislative history, [redacted] is precluded from deducting the discounted present value of payments due over the term of the easements granted to [redacted] when such amounts have not actually been prepaid. [redacted] can only deduct amounts paid for its right of way easements at the time the

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Treas. Reg. § 1.460-1(b)(2) and Notice 89-15, 1989-1 C.B. 634, Q&A 4.

property is actually used, or ratably over the term of the easement.

Issue 4

In some cases, [redacted] has prepaid its liability for the easements granted to it for a term of generally [redacted] years. These easements are also in part used by [redacted] and in part transferred to its long-term contract customers. Under the circumstances of actual prepayment, [redacted] is entitled to deduct prepaid amounts for that portion of the liability associated with the long-term contracts. Treas. Reg. § 1.461-4(d)(2)(ii) provides that for expenses attributable to a long-term contract with respect to which the taxpayer uses the percentage of completion method, economic performance for purposes of deductions occurs, as relevant here, when the taxpayer makes payment.

[redacted] has capitalized the entire amount of the prepaid easement liability to its first long-term contract customer using this easement. [redacted] itself, however, uses approximately half of the [redacted] access rights to the easement. [redacted]'s share of the expense of the non-exclusive easement is not associated with a long-term contract, but rather with [redacted]'s self-constructed assets. [redacted]'s share of the easement expense, therefore, is not governed by Treas. Reg. § 1.461-4(d)(2)(ii), but rather must be amortized over the life of the easement under Treas. Reg. § 1.461-4(d)(2)(i).

Issue 5

[redacted]'s transfers of the use of the right of way easements to the [redacted] customers in connection with long-term contracts also are not sales or exchanges, as discussed above. Nevertheless, the customers prepay their liability for the use of these approximately [redacted] year easements.

The customers' payment in connection with the long-term contract attributable to the use of the easement over the term of the transfer is income to [redacted] at the time of payment. Treas. Reg. § 1.451-5(b)(3) provides that in connection with advance payments associated with long-term contracts, such payment is included in income in the taxable year in which properly included in gross receipts pursuant to the taxpayer's method of accounting for the long-term contract.

[redacted]'s method of accounting for its long-term contracts is percentage of completion, based on percent of [redacted] miles completed. Thus, [redacted] must recognize that part of the long-term contract price attributable to the portion of the non-exclusive easement transferred to its customers under the percentage of completion method. Revenues from advanced rentals are treated the same as other kinds of revenues. See Treas. Reg. § 1.61-8(b) (gross income includes advance rentals); Kohler-Campbell Corp v. United States, 298 F.2d 911 (4th Cir. 1962)(prepaid rent from sublessee was held by taxpayer under an unrestricted claim of right and was taxable income when received). Thus, [redacted] would recognize the advance rental revenues according to the percentage of completion of the project.

If you have any questions, please do not hesitate to contact us.

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